



1948



Monthly Letter on Economic Conditions Government Finance

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General Business Conditions

THE business news during May has strengthened expectations that activity in most lines will continue high in the months ahead, and that the industries as a whole will continue under pressure to meet the demands that are on hand or in sight. Industrial production has made a good recovery from the drop caused by the coal shutdown, except in the automobile industry. There steel shortages, the Chrysler strike, and Ford's change-over to new models have curtailed May output substantially. Steel production was reduced some 1,600,000 tons by the coal strike, according to Iron Age. One of the results will be fewer automobiles this year. Buyers will have to wait longer for cars, but the deferred demand is correspondingly greater.

Since February, when the drop in commodity prices raised questions as to whether the boom might be subsiding, bullish interpretations of the outlook have been stimulated anew. The Euro-

pean Recovery Program has been adopted, taxes reduced, and increases in armament projected. Confirmation of the strong prospect for most capital goods industries has been provided not only by continued large orders, but by a government survey which indicated that corporation expenditures for plant and equipment this year would reach \$18.7 billion, compared with \$16.2 billion in 1947. Favorable building figures, with contract awards for the first four months of the year up 30 per cent from the same period a year ago, also belong on the list.

New Stimulating Influences

To these factors have been added during May the Treasury decision to maintain for the present the 1½ per cent rate on one-year Treasury certificates of indebtedness. This decision, discussed in detail on a later page, suspends for the time being the policy of firming up short money rates as a means of discouraging credit expansion. Thus it defers for an undetermined period the use of a brake on inflationary forces which many people thought desirable and which they expected to be applied. The decision has been interpreted to some extent as a green light, and it has been followed by a rise in bond prices and also — whether the connection is causal or not — by a great increase in stock market activity and a sharp rise in stock prices to the highest since the Fall of 1946.

Finally, the grant by the General Motors Corporation of an 11c per hour wage advance is generally viewed as setting a pattern for the industries which the third round increase so far has not reached. The implication of this settlement is that prices will also be raised in some cases, and that price reductions which have been or might have been made will now be abandoned. Basic commodity prices also have been firm during the month.

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Taken together these developments have a stimulating influence upon business and investment sentiment, and upon buying policy. They strengthen expectations of full employment, high purchasing power, and, in the main, firm prices. Their weight in the scales so far as it goes, is on the side of a renewal of inflationary trends. To be sure, other influences are working the other way. They include the filling up of pipe lines and of accumulated wants, the steady shift from sellers' to buyers' markets in various products, the pricing of goods out of the markets which occurs when costs and prices get out of line with incomes of various groups of the population, and the restraint that is imposed on both corporations and people as debt increases and liquidity declines.

The Analogy with 1947

In the course of events since last February there are obvious similarities with the Spring of 1947, when a period of hesitation and of slackening demand in some lines, such as has been seen this year, was followed by a turn-around and renewed upward movement. Then the Marshall plan was taking shape; now armament increases are in the making. Then the second round wage increases took effect; now it is the third round. But while these similarities exist the differences are substantial, and the analogy should not be pushed too far.

A significant difference is that prospects for European wheat crops and for the United States corn crop, so far as the latter can be judged at this early date, are strikingly better. Instead of a violent advance in grain prices, as happened last year, declines may occur this year if crop prospects hold up. Another difference is that the third round wage increase is smaller, and that man-hour production in the industries in many cases has improved. A third difference is that the inflationary boom is a year older, present and potential production is larger, accumulated scarcities are less acute, and monetary and financial influences are less positively stimulating.

To the extent that similarities with 1947 exist they can only be regarded as menacing. The longer the inflation runs and maladjustments in costs and prices, wages and income distribution persist, the more certainly will excesses occur and weaknesses develop and the more severe the reckoning will be when it comes.

In truth, a new vocabulary is needed to write of economic conditions during inflationary booms. When the outlook is for full employment, high

production and peak incomes as at present, such terms as "confidence", "optimism", "encouraging" and "favorable" are customarily used. But even though they apply to the present situation in a limited sense, and within some perhaps fairly long but nevertheless limited time, their use now is inappropriate. To describe an inflationary condition which receives repeated stimulants and runs on almost without pause as encouraging or favorable, or to suggest that it generates true optimism or confidence, is to misuse the words. For the confidence is surrounded by doubt, the optimism weakened by a sense of uneasiness and impermanence. The truly encouraging or favorable developments are those which tell of economy, restraint, thrift and harder work, all promoting stability and sound progress, rather than those which signify continued inflation of demand beyond ability to supply and which expend their force in the wage-price spiral.

The General Motors Wage Increase

The 11c wage increase granted by General Motors is divided into two parts. First, a cost of living adjustment of 8c an hour is made, based on the fact that since 1940 the consumers' price index of the Bureau of Labor Statistics has risen somewhat more than the company's wage rates. Second, an "annual improvement factor" of 3c an hour, to increase the standard of living of workers, is given for the next twelve months, and an additional 3c will be given for the second twelve months of the two-year contract. It is further provided that the base rate will be increased or reduced each quarter according to changes in the consumer price index. The rate will change 1c an hour for every rise or decline of 1.14 points in the index, subject to a provision that any cut reflecting lower living costs cannot exceed 5c during the life of the contract.

As already stated, this settlement is widely expected to set a pattern that other large employers and industries must follow, including those which heretofore have refused wage increases and cut prices as a contribution to stability. Because of the size and position of leadership held by General Motors, the influence of its action is certain to be widespread. Nevertheless, it should be noted that a strict application of the General Motors formula to most other industries would not produce an 11c increase or anything like it. The factor which accounts for 8c of the increase, namely, the lagging of the rise in hourly wage rates behind the rise in the cost of living since 1940, is exceptional — in fact, almost peculiar to the automobile industry. In the overwhelming

majority of industries wages have outrun the cost of living by a good margin. The increases given by the automobile manufacturers have been well up to the average in dollars and cents, but in percentage terms they have lagged because automobile workers were among the highest paid in the country in the base period. Pertinent figures are given in the following table:

Wages and Living Costs

	Average 1940	Latest Month 1948*	% Change
Consumers' Price Index (1935-1939 = 100)	100.2	169.3	+ 69.0
Average Hourly Earnings			
Automobiles	94.8c	155.1c	+ 63.6
Other transport. eqpt.	79.5	148.2	+ 86.4
Iron and steel products	75.5	140.8	+ 86.5
Electrical machinery	72.8	134.9	+ 85.3
Bituminous coal mining	88.3	182.6	+ 106.8
Construction (private bldg.)	95.9	180.9	+ 88.6
Durable goods manufacturing	72.4	135.7	+ 87.4
Non-durable goods manufacturing	60.2	122.0	+ 102.7
All manufacturing	66.1	129.0	+ 95.2

*Consumers' Price Index, April; Av. Hourly Earnings, Feb.
Source: U. S. Bureau of Labor Statistics.

This table shows first the increase in the consumers' price index, which is 69 per cent, followed by figures of average hourly earnings of certain major industries and groups. It will be seen that the automobile wage was the only one in these major groups to lag behind living costs. In bituminous coal Mr. Lewis's successes show themselves in a wage increase of 106.8 per cent, making the miners the highest paid, both relatively and actually, of these groups. On the average, manufacturing workers have had wage increases of 95.2 per cent, against the 69 per cent increase in living costs. A thorough-going application of the General Motors formula therefore could not result in an 11c pattern, but would eliminate the 8c from it.

It is hardly to be expected, however, that leaders of unions other than the automobile unions will base their demands on the grounds of a loss of purchasing power since 1940, inasmuch as the figures are so plainly against them. Each will want as much as the other receives, and each will use only the arguments thought to be most favorable to his own case. The fact that General Motors workers get 11c will be the argument most emphasized.

Cost of Living Adjustments

The provision for an adjustment of wages according to changes in living costs is another feature of the General Motors settlement in which there is deep interest. Such arrangements are not new, but they have never become numerous, in part because the unions oppose formulas which may cause automatic wage reductions. The lim-

itation of the possible cut in the next two years to 5c, against which the 3c further increase in May, 1949, is an offset, was doubtless a factor in the unions' acceptance in this case.

It has always been recognized that wage rates in practice must be related to living costs in a substantial degree, but the weight of opinion has generally been against formal or automatic tie-ups. During the war the National War Labor Board was guided by the following principles ("Wage Report," Feb. 22, 1945, page 40):

1. To prevent inflationary spirals, it must be recognized that wages cannot be automatically adjusted to increases in living costs. (The Board says: "This principle has become a foundation stone of the wage stabilization program.") . . .

3. To the extent that it can be done without inflationary effects . . . fair and reasonable upward wage adjustments should be made as an offset against increases in the cost of living.

In striking a balance between these two principles, it must be considered that, under conditions of full employment and accumulated demand, wage increases tend to push up the cost of living even when they do not result directly in higher prices for the products made by the workers who get the increases. Rising living costs mean that there is a greater demand for goods at existing prices than can be supplied. Wage increases add to the demand. But unless they are offset by increasing productivity they do not increase the supply. If all workers get wage increases, living costs are pushed up all around. The efforts of any group to improve its position by keeping its money wage rates above the cost of living can succeed only at the expense of other groups. For all groups to improve their position without increasing production would be impossible. General adoption of automatic upward wage adjustments would therefore be self-defeating. Under inflationary conditions, with which we are now concerned, it would accelerate the spiral.

On the other side of the argument is the fact that provisions for automatic adjustment would doubtless help overcome the "stickiness" or resistance to reductions when excessive wage costs were causing unemployment and depression. However, it is precisely for this reason that unions generally oppose such arrangements, or accept them only with limitations as in the General Motors case.

In summary, the third round wage increase, which now seems likely to run its course through the industries, is inflationary in character, and with the present insistent demand for goods it

will add to the upward price pressures. To be sure, the increases are more moderate than in the first and second rounds, they are less than the unions demanded, and they may save the waste and strife of great strikes.

Evidence of Labor Attitudes

Evidence of changes for the better in labor conditions and attitudes is not lacking. The strike against the packers was complete economic waste and loss for the workers, who after weeks of idleness settled for the 9c increase they were originally offered. This may have been in the minds of the General Motors workers, led by the Buick local in Flint, Michigan, who voted against a strike call. A dispatch by the Associated Press says:

From the floor came shouts from some of the men who walked the picket line for 113 days in 1945-1946 during the last General Motors strike.

"We lost our homes, our furniture, our cars then," one member cried from the floor. "Now they want us to do it again."

A cheer was raised as Roger B. Townsend, recording secretary of the local, told the meeting: "I can remember when Walter P. Reuther told us from this same platform that we would be the shock troops in a struggle to end all wage struggles with G. M. We hit the picket line for 113 days, but all we got was a contract which even our own officers said was no good.

"Now they are asking us to hit that line again. I don't think it is right."

This marks a heartening change in labor attitude. If it can be followed by increased man-hour output the inflationary effects of the wage increase can be reduced or minimized. The fundamental truth is that the remedy for rising living costs is not higher money wages but increased production.

The June-July Refundings

The money and security markets were treated to a surprise Thursday, May 13 when the Treasury Department announced the terms of refunding \$1,777 million $\frac{3}{8}$ per cent certificates of indebtedness maturing June 1 and \$3,062 million 1 $\frac{1}{4}$ per cent bonds coming due June 15. Abetted by "inside" hints, and by apprehensions of fresh inflationary pressures voiced by responsible officials of the Federal Reserve System, the expectation was general that the Treasury would choose the occasion to shift from the 1 $\frac{1}{4}$ per cent rate for one-year money to 1 $\frac{1}{2}$ per cent. Instead, the decision was to keep the 1 $\frac{1}{2}$ per cent rate.

To eliminate uncertainties which might have threatened the success of the June 1 conversion, the Treasury disclosed that more one-year 1 $\frac{1}{2}$ s

would be offered in exchange for the \$6,078 million certificates falling due July 1. Any change in refunding terms is thus deferred until September, at the earliest, when \$3,748 million 1 $\frac{1}{2}$ per cent notes fall due.

The Treasury's decision was interpreted as an official suspension of the policy of keeping a restraint on credit expansion by increasing the attractiveness of short-term government securities as an investment medium. As a matter of fact, the actual rise in rates on short-term governments came to an end in January, when 1 $\frac{1}{8}$ per cent on one-year certificates was first offered. The same terms were maintained on the February and March certificates and bond refundings. However, expectations of a higher rate, if not in April, then certainly in June or July had acted as a restraining influence on lending and investing policies. A "rollover" of a small issue of certificates in April, still at 1 $\frac{1}{8}$ per cent, occasioned little comment. But the extension of the same rate through the entire Spring and Summer, as has now been scheduled, involves a major review of plans and portfolios by investing institutions generally.

In the shorter term government list, the keen demand for June and July maturities, carrying the "rights" to exchange for the new certificates, evaporated when the announcement came out. Demand shifted into longer term government securities, or into corporate or municipal issues.

The government bond market responded to the announcement with the strongest rise in two years. The longest term Treasury bonds eligible for bank purchase jumped three-quarters of a point or better and the Victory Loan 2 $\frac{1}{2}$ s, ineligible for bank purchase, rallied a half point to 100%. The markets for corporate and municipal obligations showed a sympathetic strengthening. The stock market, interpreting the move as inflationary, responded with a burst of buying which carried quotations to the highest levels since September, 1946.

The Case for the Higher Rate

The decision, which will affect innumerable lending and investing decisions in the period ahead, was contrary to the advice of Federal Reserve officials who have been consistently concerned by a possible re-emergence of strong inflationary pressures. The most recent and thoughtful statement of the case in favor of going ahead with the gradual rise in short-term interest rates was made by Allan Sproul, President of the New York Federal Reserve Bank, in testi-

mony before the Congressional Joint Committee on the Economic Report May 12. While Mr. Sproul did not refer to the terms of the June and July financing specifically — the decision on which was impending — the import of his own recommendation was almost unmistakable.

After reviewing the success of the program of credit restraint previously undertaken, Mr. Sproul warned that the proposed increases in military expenditures and tax reduction, plus continuing foreign aid,

have created a new situation with respect to the coordinated program of credit policy and debt management which we have been pursuing to restrain the expansion of bank credit. A main reliance of that program, a whacking surplus in the cash budget, has been taken away from us. There are various estimates of what the fiscal results of the year 1948-49 will now be but, with the possible exception of some Congressional committee estimates, they don't leave us much fiscal ammunition.

Whether there actually will be a revival of strong inflationary pressures, accompanied by increased and inflationary demands for bank credit, Mr. Sproul did not venture to predict. But if there is, he intimated that policies of credit restraint might have a larger role to play than in the immediate past. "Our existing program of credit control," he said, "won't be in working order much longer without some adjustment." This adjustment, in Mr. Sproul's view, would be to

proceed further with increases in short term rates, so as to maintain a healthy degree of uncertainty as to future action, so as to keep the banks liquidity conscious, and so as to encourage them to use whatever reserve funds come into their possession (through gold imports, return flow of currency, Treasury expenditures, or otherwise) to purchase short Governments from us.

Opposing Considerations

No official statement has been issued giving the considerations which underlay the Treasury's decision to hold to the 1½ per cent certificate rate although Secretary of the Treasury Snyder pointed out that when "an appropriate time" arrives we will "not be frozen in our position — we would try to remain flexible." It was clear the decision had been made after canvassing not only views in official circles but of bankers and market observers outside the government as well.

It seems fair to conclude from Mr. Snyder's comments that the question of timing was vital. The drop in farm prices and official forecasts of further declines as the new crops come to market, the slowing or cessation of price advances in some other directions, the tightening up in the credit supply that has occurred, and the possible falling off in business capital expenditures, have been among the factors which might suggest caution in carrying on further measures of credit restraint.

There has been a feeling, in at least some quarters, that the restrictive measures applied during the latter part of 1947 and the early part of 1948 were adequately effective. And no responsible official wants to take a risk of tipping the scales in the direction of a general downturn in business activity — especially at this juncture in national and international affairs.

Effects

The rising quotations for government bonds took many government security portfolios out of the red and into the black, reversing the process of last December. As governments rose, the tone of related markets for corporate and municipal obligations improved, some inventories of undistributed issues were cleared out, and a little cheaper basis for long-term financing established.

Short-term interest rates were generally undisturbed but it is natural to expect more active competition for available loan outlets as banks and other lenders seek this channel to improve income returns on their funds. If the demands for funds hold up or increase, the Federal Reserve Banks may find themselves under the necessity of intermittent buying to support the prices of short-term government securities.

Thus the effect of the move is to treat the economy to a fresh dose of easy money. Whether this will prove wise over the longer run many people will question, though admittedly the answer is for the future to tell. This much, however, is clear, that the authorities must now move quickly and vigorously when and if inflationary pressures threaten again to get out of hand.

The Federal Reserve authorities will hardly feel free, at least until the July refunding is out of the way, to reduce their support levels for short-term government securities — which now have become the weaker end of the market. Yet there are other powers which can be put to use whenever desired to rein the forces which may be stimulated by this newest phase of policy — selling longer term government securities out of the Federal Reserve portfolio, raising discount rates and reserve requirements. Of these powers, sales of long-term governments are the most flexible and easily controlled weapon. Through the week ended May 26, however, none of these powers had been put into effective use.

U. S. Imports Rise

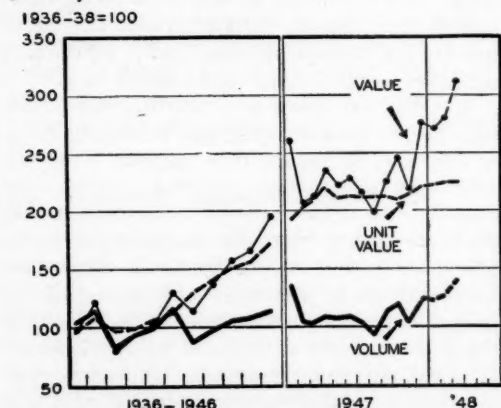
The value of U. S. imports for consumption reached an all time record in March of \$639 million. During the first quarter of 1948 we spent \$125 million more a month for foreign goods

than in the same period of 1947. At this level imports are at a rate above \$7 billion a year, against \$5.6 billion in 1947 and \$4.8 billion in 1946. Part of the gain represents higher prices, which are up about 10 per cent on the average from last year, but volume also has increased substantially.

Although the contrary idea persists in some quarters, this expansion of our purchases abroad is altogether healthy and encouraging. Continued at the current rate, our purchases will provide foreign countries with nearly one and a half billion extra dollars this year as compared with last, which they can spend for purchases or for payments here. At the same time, we receive goods to help meet our needs, fill our shelves and combat inflation, and we are supplementing our national resources, which for some six years have been under the strain of extraordinarily heavy exports.

Influences Affecting Imports

Practically all classes of goods have been included in this expansion of imports, and most of the major trading areas have participated. Apart from higher prices, contributing factors have been the continuation of our domestic business activity at record peacetime levels, recovery of production abroad and pressure to obtain dollars, replenishment of our supplies of certain industrial materials and the lowering of U. S. tariffs last January 1.



Indexes of Changes in Quantity, Unit Value, and Value of United States Imports (1936-38 = 100)

Source: Survey of Current Business (Bureau of Foreign and Domestic Commerce).

It is appropriate to say in passing that the extent of the reduction in United States tariffs in recent years, beginning with the passage of the Reciprocal Trade Agreements Act in 1934 and culminating in the agreement on tariffs and trade negotiated last Fall in Geneva by 23 nations, is

not always realized either in this country or abroad. Much foreign comment pictures American tariff policy as a major obstruction to world trade and world recovery, — arguing that it impedes the sale here of foreign goods necessary to pay for American goods and for American loans and investments. But the reductions effective January 1 bring our tariff structure at least as low as that of the Underwood Tariff of 1913, which was considered a liberal tariff. Foreign producers criticize our protective duties on certain articles. Nevertheless, the United States market generally is freer of access than practically any other market in the world. Comment which exaggerates the effect of our tariffs in preventing the balancing of trade tends to weaken the emphasis on the real problems.

Whether imports will hold at these levels is of course impossible to foretell. They are still low when compared with our current production, according to past relationships. As will be seen from the accompanying chart, the physical volume of our imports during the first quarter of 1948 was not quite 30 per cent above prewar. If the totals bore the same relation to industrial production as in average prewar years, we should now be importing goods worth \$10 billion at current prices, instead of \$7 billion. Relatively, however, our imports have been declining over a long period of years, reflecting an increase in self-sufficiency in various lines. What the net effect of wartime changes upon these relationships may be is still difficult to say. The war accelerated the trend toward self-sufficiency in some respects (i.e., synthetic rubber); but other important factors, including our greater dependence on such imports of foreign raw materials as oil and metals, work the other way.

Commodity Import Trends

A feature of our trade during the first quarter of 1948 was a considerable increase in imports of nonferrous metals and of ferroalloying materials. Prices of these commodities are generally higher than last year; also, stockpiles accumulated during the war have been drawn down, and it has become necessary to cover more of current consumption by imports. With rearmament looming ahead, stocks need rebuilding.

Higher imports of tin and rubber reflect the gradual restoration of production in Southeastern Asia. Although the value of rubber imports is shown below last year's, the physical volume is actually up. The current price of rubber is 5 to 6 cents below the pegged prices of a year ago.

Value of U. S. Imports of Selected Commodities
(In Millions of Dollars)

	Year	First Quar.	First Quar.
	1947	1947	1948
Coffee, raw or green	\$600	\$174	\$194
Wood pulp and newsprint	600	118	173
Wool, raw	209	68	105
Crude petroleum, gas, fuel oil	247	69	95
Rubber, crude	823	102	85
Sugar	410	77	80
Cocoa	152	85	72
Undressed furs	121	25	46
Copper	144	20	45
Hides and skins	86	21	44
Lumber, boards, planks	101	26	35
Jute and burlap	120	26	33
Diamonds, cut uncut, industrial	110	13	33
Machinery and vehicles	67	15	33
Nickel and ferroalloying ores	95	23	32
Nonferrous concentrates	101	13	25
Tin	43	2	16
Woolen textiles	34	8	12
Cotton textiles	24	7	10
Silk and silk manufactures	13	1	6

The increase in imports of petroleum and petroleum products reflects the great expansion in our consumption and inability to develop domestic resources as rapidly. In the case of crude oil, for the first time in a quarter of a century, we are on an import basis. We are beginning to draw more on outside sources of lumber, wood pulp, and newsprint for much the same reason: domestic resources are either not large enough or cannot be developed quickly enough to satisfy the bulge in demand.

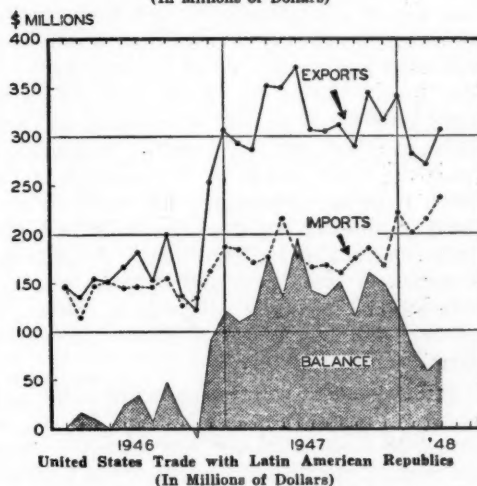
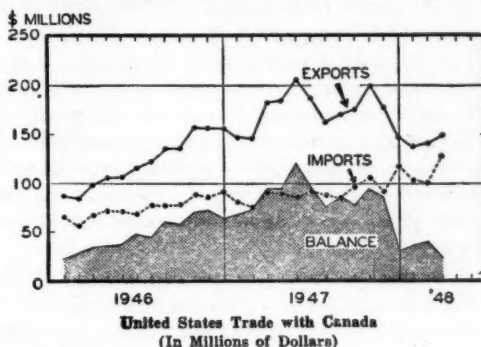
A possible temporary influence is that we are now getting increased shipments of commodities held back for the lowering of the tariff on January 1. This is true of textiles and textile fibers, particularly wool. Our dependence on foreign wools has risen. Imports of machinery and vehicles, which more than doubled as compared with a year ago, are indicative of Western Europe's determination to expand production and dollar sales.

Adjustment of Dollar Purchases

The expansion of our overseas purchases at this time helps in some degree to ease the situation of various countries whose accumulated gold and dollar resources have been depleted, and which accordingly have had to tighten their import controls, suspend or delay dollar payments, and reduce purchases of U. S. goods. As will be seen from the first of the charts opposite, the unfavorable balance which Canada has to meet in trade with us dropped during the first quarter of 1948 to less than half the 1947 average. This was due not only to the import restrictions imposed by the Dominion in mid-November, but also to expansion of sales to us, of forest products and newsprint in particular.

The general truth that the more goods we import, the more U. S. goods our customers can buy, is demonstrated in our current trade with

the Latin American Republics. Many have practically used up their gold and dollar reserves accumulated during the war. The problem of fitting dollar expenditure to dollar earnings is acute. Dollar payments from Brazil are greatly



delayed, and Argentina resorted last month to the drastic measure of suspending temporarily all exchange permits involving dollars. Nevertheless, our exports to Latin-America are holding up surprisingly well, as will be seen from the second chart. At the same time the unfavorable balance they have to cover is down substantially from last year's average. Our heavier imports, now at an annual rate of better than \$2.6 billion, as compared with \$2.1 billion in 1947, have helped ease their adjustment.

A number of other countries have benefited from our expanding imports: the Philippines, the Netherlands, East Indies, Malaya, Japan, British West Africa, Union of South Africa, Belgian Congo, Great Britain, Sweden and Italy. In turn some of these countries such as the Philippines, the Netherlands, East Indies, the Belgian Congo, and the Union of South Africa continue to buy

from us at a rate close to, or even better than, the 1947 record.

Hope for Better-Balanced Trade

In summary, the rise of imports to an annual rate in excess of \$7 billion is in the right direction, and it is a contribution to world recovery. It is one side of an exchange of goods which is beneficial to ourselves and to foreign countries. We are increasing our wealth and prosperity by accepting in trade goods that we cannot produce ourselves or of which supplies must be safeguarded in the national interest. Increased imports place an additional brake on inflationary forces.

But there is even broader significance to the rise in our imports. It heralds the expansion of production abroad, and to some extent also progress toward a better adjustment between foreign price levels and ours. For too long a time since the war's end, foreign countries have looked to the United States for goods without having equivalent goods to offer in exchange at prices Americans will pay; the resulting unbalance is what the world knows as "the shortage of dollars." Recovery of foreign production and more American imports together achieve both a better-balanced trade and a larger trade. A better distribution of production and a better balanced international exchange of goods is one of the prerequisites for the establishment of international monetary stability.

In combination with the spending of the Economic Cooperation Administration for the so-called off-shore purchases, our increased outlay for imports should help to check the tendency toward bilateral trading which has become marked since the pound sterling crisis last Summer. The ultimate goal is to resume multilateral transactions, under which the international exchange of goods would become more flexible and goods would move more readily to the places where they are needed. The goal is still far off but we are making some progress.

Rising Plant and Equipment Costs

The sharp rise in plant and equipment costs has created increasingly acute problems for business since the war in financing the record program of repairs, improvements, replacements, and expansion of productive facilities. Many corporations in their 1947 annual reports devoted considerable space to these problems, and cited figures showing replacement costs last year ranging 50 to 100 per cent or more above original costs.

In the manufacturing and mining industries, expenditures have been particularly heavy for deferred maintenance and postwar reconversion, followed by improvements and increased capacity to meet the unprecedented demands for steel, chemicals, petroleum, textiles, and many other products. Most of the railroads and the utility industries — electric light and power, natural and manufactured gas, telephone and telegraph, water, traction and bus — have programs for growth and improvements that involved the largest expenditures in their history in 1947 and are projected around the same rate for 1948.

Provision for High Replacement Costs

The increase in replacement costs over original costs of plant and equipment creates not only the problem of providing the actual funds to finance such replacements as they become necessary, but also accounting problems in the preparation of financial statements to reflect this advance. Since annual depreciation charges to amortize the value of fixed assets over their estimated useful life are based, according to long-established and almost universally accepted practice, upon original costs, they are in most cases at a rate far below that needed to build or purchase similar assets today. This inadequacy of depreciation currently charged against earnings causes, in a sense, an overstatement of net income. What happens is that business is selling out piecemeal its low-cost productive assets and taking the "profit" into operating income.

At the same time, the carrying of fixed assets in the balance sheet at original cost less accrued depreciation, or far below prevailing costs, results in an under-valuation of the stated "net worth" — the book value of total assets less total liabilities and reserves, represented by capital stock and surplus account. Consequently, a high return of net income on net worth may be misleading unless consideration is given both to the possible inadequacy of depreciation charges, and the fact that net worth at book value is based to a large extent upon costs before World War II, and in many cases going back to World War I or before. Because of recent changes in the price level, figures of current earnings and net worth are no longer strictly comparable, since the former is expressed in current dollars and the latter largely in prewar dollars.

Last year a number of companies, principally among the larger manufacturing organizations, made special charges in their income statements to provide for accelerated depreciation or for high-cost replacement of fixed assets. In some cases these charges were made against operating

earnings, and thus reduced the reported net income correspondingly. In other cases the charges were treated, not as deductions from but appropriations of net income, unavailable for paying out in dividends, wages, or for other purposes, and earmarked to be retained until the time for such replacements. Still other companies created or added to contingency reserves, which may be applied to fixed assets as well as to high-cost inventories, unexpected losses, etc. It appears, however, judging from the published reports, that the majority of companies have thus far made small if any special provision for the higher replacement costs.

The 100 Largest Manufacturing Corporations

With a view to giving some general idea of the difference between the balance sheet valuation of fixed assets and present-day replacement costs, an analysis has been made of the statements of the 100 largest manufacturing corpo-

100 Largest Manufacturing Corporations, Based on Total Assets Reported at the End of 1947

(In Millions of Dollars)

Allied Chem. & Dye Corp.	\$575	Liggett & Myers Tob. Co.	\$366
Allis-Chalmers Mfg. Co.	202	Mid-Continent Pet. Corp.	116
Aluminum Co. of Amer.	430	Monsanto Chemical Co.	199
American Can Co.	250	Nash-Kelvinator Corp.	138
American Cyanamid Co.	207	National Biscuit Co.	154
Amer. Rad. & Std. Ssn. Co.	153	Natl. Dairy Prod. Corp.	277
Amer. Smelting & Ref. Co.	256	Natl. Distillers Prod. Corp.	210
American Sugar Ref. Co.	133	National Lead Co.	163
American Tobacco Co.	647	National Steel Corp.	292
American Viscose Corp.	201	Ohio Oil Co.	164
American Woolen Co.	118	Owens-Illinois Glass Co.	162
Anaconda Copper Min. Co.	637	Phelps Dodge Corp.	251
Armco Steel Corp.	249	Phillips Petroleum Co.	439
Armour & Co.	421	Pittsburgh Plate Glass Co.	207
Atlantic Refining Co.	330	Procter & Gamble Co.	242
Bendix Aviation Corp.	123	Pullman, Inc.	197
Bethlehem Steel Corp.	949	Pure Oil Co.	245
Borden Company	222	Radio Corp. of Amer.	216
Borg-Warner Corp.	151	Republic Steel Corp.	455
Burlington Mills Corp.	125	R. J. Reynolds Tob. Co.	458
Caterpillar Tractor Co.	122	Reynolds Metals Co.	112
Celanese Corp. of Amer.	212	St. Regis Paper Co.	133
Chrysler Corporation	487	Schenley Distillers Corp.	318
Cities Service Co.	900	Shell Union Oil Corp.	534
Coca-Cola Co.	192	Sinclair Oil Corp.	591
Continental Can Co.	207	Skelly Oil Co.	129
Continental Oil Co.	209	Socony-Vacuum Oil Co.	1,262
Corn Products Ref. Co.	146	Standard Brands, Inc.	135
Crane Company	129	Stand. Oil Co. of Calif.	376
Curtis-Wright Corp.	166	Stand. Oil Co. (Indiana)	1,268
Deere & Co.	229	Stand. Oil Co. (N. J.)	2,996
Distillers Corp.-Seagrams	267	Stand. Oil Co. of Ohio	189
E. I. du Pont de N. & Co.	1,438	Sun Oil Co.	242
Eastman Kodak Co.	360	Swift & Co.	437
Firestone Tire & Rub. Co.	324	Texas Company	1,115
Gen. Amer. Transp. Corp.	132	Tide Water Assoc. Oil Co.	263
General Electric Co.	1,027	Union Carbide & Car. Corp.	649
General Foods Corp.	207	Union Oil Co. of Calif.	272
General Motors Corp.	2,473	United Aircraft Corp.	160
B. F. Goodrich Co.	247	United Fruit Co.	419
Goodyear Tire & Rub. Co.	408	U. S. Gypsum Co.	132
Gulf Oil Corp.	929	U. S. Rubber Co.	348
Hearst Cons. Publications	161	U. S. Steel Corp.	2,163
Inland Steel Co.	244	Walker-Gooderham & Worts	134
Inter. Bus. Machines Corp.	184	Western Electric Co.	771
Inter. Harvester Co.	620	Westinghouse Elec. Corp.	602
International Paper Co.	279	Weyerhaeuser Timber Co.	195
Johns-Manville Corp.	115	Wheeling Steel Corp.	158
Jones & Laughlin Steel Corp.	341	Wilson & Co.	140
Kennecott Copper Corp.	541	Youngstown Sheet & Tube	260

The above list excludes a number of large companies whose statements are not yet available for the 1947 calendar or nearest fiscal year, or for the years going back to 1940, including American Car & Foundry Co., Crown Zellerbach Corp., Dow Chemical Co., Ford Motor Co., General Mills, Inc., Philip Morris & Co., Ltd., Publicker Industries, Inc., Remington Rand, Inc., Singer Manufacturing Co., and J. P. Stevens & Co.

rations, measured by the total assets reported at the end of the 1947 calendar or nearest fiscal year, as given in the accompanying list. There are of course other ways of measuring size, such as total volume of sales, capital funds, number of employees, etc.

These companies, which include the largest organizations in numerous major industries, had total assets aggregating \$41.6 billion at the end of 1947 and comprise a substantial portion of the total production and employment of all manufacturing corporations. Their total number of employees in 1947, based upon the year-end or annual averages, approximated 4,000,000. This represented an average investment in assets of \$10,000 per employee. The capital stock was owned by more than 5,000,000 registered shareholders, a considerably larger number than the total of employees. While the total number of shareholders of the group includes duplications to the extent that many individual and institutional shareholders own stock in more than one of these companies, many a registered "shareholder" is a financial institution or nominee holding in trust stock for numerous beneficiaries.

Although no means are available for an accurate estimate of how present-day costs of plant and equipment of a large group of companies such as this compare with the book values at which they are carried on the balance sheets, an adjustment of the latter figures by changes in the index of industrial building costs compiled by the Engineering News-Record should afford a useful approximation.

This widely-used index, based upon labor and material costs, obviously would not measure accurately the change in costs of all the diversified assets used in all types of industries represented. Book valuations of fixed assets vary also with the dates, in some cases running back many years, at which they were originally acquired, as well as the rates at which they have been amortized. Valuations often are affected by adjustments in connection with purchase and sale of plants, disposal of government war surplus, reappraisals, recapitalizations, reorganizations, and mergers. Corresponding reductions in capital and surplus account of many companies have resulted from writing down fixed assets as well as intangibles.

The Engineering News-Record and similar indexes, however, trace the rising trend of costs, and the effect if all fixed assets should be replaced at prevailing prices. They indicate the competitive conditions under which a new company would start in business.

100 Largest Manufacturing Corporations (In Millions of Dollars)

Sales and net income	1940	1945	1947
Total sales and revenues	\$20,600	\$39,900	\$50,600
Net income after taxes	1,875	1,943	3,780
Dividends (preferred & common) paid	1,197	1,208	1,668
Net income per sales dollar	9.1c	4.9c	7.4c
Dividends paid per sales dollar	5.8c	3.0c	3.3c
Plant and equipment, net worth, and rate of return, based upon reported balance sheet book values of plant and equipment.			
Plant and equipment, 1940 total	24,448	24,448	24,448
Additions 1941-45		8,748	8,748
Additions 1946-47			6,225
Total to date	24,448	28,196	34,421
Less: Reserve for depreciation	11,701	16,145	17,745
Net total to date	12,747	12,051	16,676
Net worth end of year	18,701	22,227	26,093
Rate of return—net income to net worth	10.0%	8.7%	14.3%
Plant and equipment, net worth, and rate of return, adjusted to approximate replacement costs of plant and equipment*			
Plant and equipment, 1940 total	24,448	28,440	38,386
Additions 1941-45		8,990	5,386
Additions 1946-47			7,140
Total to date	24,448	32,430	50,912
Less: Reserve for depreciation	11,701	16,145	17,745
Net total to date	12,747	16,285	33,167
Net worth end of year	18,701	26,461	42,584
Rate of return—net income to net worth	10.0%	7.3%	8.8%

*Plant and equipment adjusted by changes since 1940 in the Engineering News-Record Index of Building Costs (1913=100) from 208.2 in December 1940 to 242.2 in December 1945 and to 326.9 in December 1947, applied to the total plant and equipment in December 1940, plus the additions during 1941-45 at an assumed average cost of 227.5, plus the additions during 1946-47 at an assumed average cost of 285.0.

Total sales and other revenues of these companies, including estimated or preliminary figures for a few companies on which complete operating details are not available, increased from approximately \$20.6 billion in 1940 to \$39.9 billion in 1945 and \$50.6 billion in 1947.

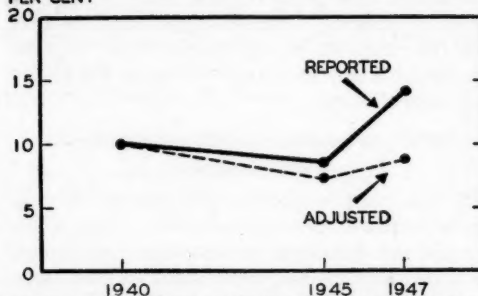
Net income after taxes totaled approximately \$1.9 billion in both 1940 and 1945, but rose sharply to \$3.7 billion in 1947. The average margin of profit, which together with return on net worth is the most widely-used measure of earnings, declined from 9.1 cents per dollar of sales in 1940 to 4.9 cents in 1945, and rose to 7.4 cents in 1947. As pointed out earlier this year when presenting our annual tabulations of corporate earnings, the large dollar total of net income last year was due chiefly to the enormous expansion in volume of business and not to an unusual widening of profit margins, which in most cases (with some important exceptions) were actually narrower than in former years of active business.

Upon the book net worth totaling \$26.1 billion at the end of 1947, the net income represented an average return of 14.3 per cent, compared with 8.7 in 1945 and 10.0 in 1940. In this comparison, however, the kinds of dollars are different—net income is expressed in current dollars, but net worth is based largely on prewar dollars of much greater purchasing power.

If plant and equipment, carried at \$34.4 billion (before depreciation) at the end of 1947, had been adjusted to 1947 costs, by applying the changes since 1940 in the general index

of building costs, the valuation would be lifted by \$16.5 billion to \$50.9 billion, and book net worth would be lifted by an equal amount. Upon this enlarged base, the reported net income in 1947 represents an average return of 8.8 per cent, actually lower than in 1940. The apparent gain arises from the under-valuation of assets. A comparison between return as reported and as adjusted is given in the chart below.

PER CENT



Average Rate of Return on Net Worth of 100 Largest Manufacturing Corporations, Based upon Balance Sheet Book Values of Plant and Equipment as Reported, and upon Plant and Equipment Adjusted to Approximate Current Replacement Costs.

Earnings and New Capital

It should be emphasized that this attempt to adjust for changes in replacement costs should not be taken too literally, but is illustrative of the upward price trends and the problems they have created. This matter of replacement costs is but one of the many factors to be considered in judging earnings. It is not an argument for companies to write up the book value of their assets to current costs as a new basis for computing earnings, since no one knows what the trend of prices may be in the future or at what dates the various assets will have to be replaced. By the same token, however, there is an obvious danger in ignoring replacement costs in determining wage rates and pricing policies.

The 1947 earnings of many companies have been criticized, in some quarters, as excessive; yet often the same companies, having made vast expenditures from their own and borrowed money for expansion of plant capacity, have been criticized, in the same quarters, for not spending still more in order to meet the apparently insatiable domestic and foreign demand for their products, and also for not increasing wage rates further. The retained earnings of prior years, though designated on the balance sheet as "surplus", are not in the form of cash but already have been invested in fixed and working assets.

For this group of large corporations, the payments of wages and salaries have in fact increased much more proportionately than have

dividends paid to the shareholders owning the business. Total payrolls in 1940 approximated \$5.5 billion and were about 4½ times the dividend payments, while by 1947 total payrolls had expanded to \$12.6 billion and were 7½ times dividends.

Average annual compensation per employee rose from \$1,800 in 1940 to \$3,100 in 1947, an increase of 72 per cent, which was more than the rise during the same period in the Bureau of Labor index of consumer prices, amounting to 59 per cent.

As the dollar total of dividend payments increased only 39 per cent from 1940 to 1947, despite an increase of the same percentage in shareholders' equity from retained earnings and new stock issues, the shareholders as a group lost ground in terms of the purchasing power of their income.

If business is to continue its long-term growth trend, to produce more goods at reasonable prices for the American people and to provide more jobs at high wages, then good earnings are essential to build and attract the new capital needed. Business is being called on to raise capital for financing the expansion of facilities for increased output of steel, greater petroleum production and refining, growth of public utilities, mechanization of coal mines, super-markets to lower food distribution costs, and so on.

Under present conditions, retained earnings are relied upon as the chief source of new capital. Sale of new preferred or common stock is limited by a generally unreceptive market for new equity securities. Borrowing has the effect of increasing the debt ratio, and if carried too far runs against the credit control policies of the monetary authorities. Even if funds are raised in part from these alternative sources, the maintenance of good earnings is still required to justify the loan or investment.

What! The Profit Motive!

In the New York Herald Tribune of May 24 there appears the following despatch from that newspaper's Moscow Bureau:

Moscow, May 23. — Following a recent warning against factories operating at a loss, it was reported today that a number of Soviet plants are now earning impressive profits.

For the first four months of 1948 the Stalin automobile plant made eleven million rubles profit. The first state ballbearing plant earned eight million rubles and the Electrostat plant nearly four million rubles.

These profits were listed in "The Agitators Handbook" which is issued to Communist agitators and propagandists to guide them in their work. Communist agitators are now able to use this material in other factories to strive for profits.

What heresy is this, in the country that — we are told — has abolished the "profit motive" and where production "for use" and not "for profit" is supposedly the guiding incentive! Yet here an official organ of the Soviet Government announces with evident satisfaction that, following "warnings", certain Soviet plants that previously operated at a loss are now reporting impressive profits. What is more, these examples are to be used to incite other factories "to strive for profits".

This all seems very confusing in view of what we have had dinned into our ears from collectivist sources as to the iniquities of profits. Apparently, the "profit motive" and "production for profit" are not so easily dispensed with as Socialist and Communist literature would have us believe.

To be sure, profits under the collectivist system go to the State, and under the capitalist system to those individuals whose enterprise, capacity, and savings have created the industries. But the fact is — as the above quotation only goes to show — that profits there must be, whether the regime be capitalist or communist, if capital is to be had for progress and development, unless industry is financed by forced labor or by taxes upon the people. While the Soviet Government continues to exploit both these latter sources, the drive for profits is recognition that even state-owned enterprises must make money if they are not to be a drag on the economy. As regards individual incentives, the Soviets early in the game discovered the need for providing the inducement of personal gain to stimulate effort, as demonstrated by the widespread use of production-bonus systems among the workers and the great disparity in incomes between those in responsible positions and the mass of the people.

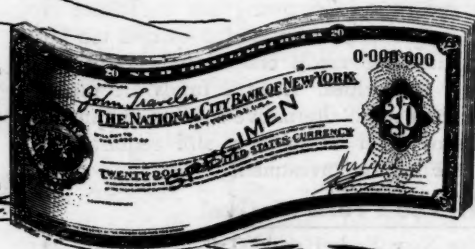
Though the Socialists make great play of the fact that profits under Socialism accrue to the public authorities rather than remain in private hands, the really important thing is not who gets the profits in the first instance, but rather the relative success of the two systems in producing and distributing an abundance and variety of goods and services which the mass of the people can use and which contributes to advancing their material welfare. By this test, free enterprise capitalism wins in a walk over any other system the world has ever known.

To most Americans there will appear a still more vital consideration — the preservation under our system of the freedom and dignity of the individual as guaranteed by the Constitution and the Bill of Rights.

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